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Value-added business success factors -- the role of financial structure and performance

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(second in a series of six)

There has been a surge of interest in farmer-owned business ventures that seek to capture additional value from commodities past the farm gate. Some of these ventures have been very successful, some marginally successful, and some have failed. Supported by funding from the Ag Marketing Resource Center at Iowa State University, we conducted in-depth interviews with farmer-owned businesses to determine the key factors that influenced the relative success or failure of these ventures. A better understanding of why some ventures succeeded while others failed provides valuable insight for the success of future farmer-owned businesses. This article focuses on the role of financial structure and performance on business success.

Research method

To identify factors having the greatest impact on the success or failure of farmer-owned business ventures, a cross-section of seven farmer-owned commodity processing businesses formed since 1990 in North Dakota, South Dakota and Minnesota were selected. Extensive interviews were conducted with individuals who played, or continue to play, an important role in the formation and operation of the business. This included leaders in the formation of the business, key members of the management team, selected board members, lenders, local leaders and others.

Research results

While the necessity of sufficiently capitalizing the business would seem to be obvious, its importance cannot be overstated. The business must be sufficiently capitalized to withstand cash flow risks during the first few years of operation. Market down-turns, crop failure and production issues can all challenge a new organization. So the business plan must allow for adequate reserves. Once the firm begins to show a profit, it is important to retain a sufficient portion of the earnings to build the business' reserves to enable it to survive future challenges. Market down-turns, crop failures and production issues can challenge even a well established business, making an appropriate business reserve critical for new start-ups. Members' desires for pay-outs must be weighed against the needs of the business for reserve funds.

Financial reserves

The business plan must provide for sufficient operating capital to carry the organization through the start-up period. Enterprises that were not successful often cited the lack of operating capital as a significant contributing factor.

Further, plant start-ups often require some fine-tuning before reaching planned capacity. Also, markets typically take time to develop. Without sufficient working capital, a glitch in production, marketing, or an industry wide disruption could prove fatal.

If the business does not build sufficient financial reserves, its only recourse when confronted by a downturn is another equity drive to raise more money from its members. Several of the unsuccessful businesses we interviewed reported having undertaken such fund raising efforts. But the efforts met with limited success given the business's recent history of substantial losses. On the other hand, some of the successful businesses conducted subsequent equity drives to finance expansions. These business's histories of making substantial payments to grower-members were credited with contributing to the success of subsequent capitalization efforts.

Lender issues

The financial partner (lender) must be sufficiently invested in the business to have an incentive to stay the course over the long term. Without that incentive, they may want out at the first sign of trouble. Two businesses were financed by a consortium of rural banks, with a USDA loan guarantee. Thus, the risk to any individual lender was relatively small. Under these circumstances, it appeared that the lenders may not have critically evaluated the project and were quick to get out when problems occurred. If the financial institution is not sufficiently vested in the business, it may withdraw if a downturn leads to the need for additional funding.

Organizational structure

Organizational structure may have an impact on some lenders' decisions to finance cooperatives. Some characteristics of the closed cooperative model may be perceived as weaknesses of the organizational form. Because of expanded access to capital through non-farmer investors, fewer restrictions on membership delivery and commodity purchases, and simplified structures for distribution of earnings, some lenders saw the limited liability company (LLC) or corporation (subchapter C) as a preferred organizational structure. In fact, all of the enterprises examined

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were either a LLC or a corporation. Some were organized as LLCs, while others had started as a closed cooperative and had since converted to a LLC or corporation. One chief executive officer we interviewed cited the need for a stream-lined decision making process as critical in the decision to convert from a closed cooperative to a corporation.

Several lenders questioning the wisdom of siting processing facilities in remote rural areas. They expressed concern that the facility's potential for resale may be less than if it were located in or near a regional trade and service center.

(Next article – Strategic Planning and Implementation)

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What's new with crop insurance in 2008

by William Edwards, extension economist, 515-294-6161, wedwards@iastate.edu

Both traditional yield insurance (APH) and several varieties of revenue insurance will again be offered to crop producers in 2008. Last year 89 percent of Iowa's corn and soybean acres were covered by some form of crop insurance. Revenue insurance has become the dominant type of coverage, accounting for over 85 percent of the insured acres.

Last year's high indemnity prices of $4.06 per bushel for corn and $8.09 per bushel for soybeans allowed many producers to lock in very attractive guarantees. Indemnity prices for 2008 may go even higher, especially for soybeans. The down side, of course, is that higher prices mean higher premiums. And, despite the high value guarantees that were purchased in 2008, payouts for losses were equal to only about 4 percent of the premiums that farmers paid in.

The newest innovation in crop insurance is a premium discount for planting certain biotech corn hybrids. The Biotech Yield Endorsement (BYE) is available to corn growers in Iowa, Illinois, Indiana and Minnesota. To be eligible for a discount, farmers must plant at least 75 percent of the corn acres in an insurance unit to hybrids that contain the YieldGuard VT Triple or YieldGuard Plus with Roundup Ready Corn 2 technologies. These hybrids can be purchased from more than 250 companies that license the technology. Discounts are expected to average about 14 percent on revenue insurance policies.

Updates, continued from page 1

Internet Updates

The following updates have been added to www.extension.iastate.edu/agdm.

Motor Vehicle Cost – A3-40

Livestock Production – Specializing While Retaining Income Diversification – B1-76

Farmer-owned Processing Business Business Success Factors – C5-225

Decision Tools

The following decision tools have been added to www.extension.iastate.edu/agdm.

Corn Stover Pricer – Use this *decision tool* to estimate a price for corn stover standing in the field or harvested and stored.

Motor Vehicle Cost Analyzer – Use this *decision tool* to calculate ownership and operating costs for a vehicle per mile and per year.